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Market Insights Series: The Benefits of Securitized Credit

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A Closer Look at Credit Risk Transfer Securities

Fixed income investors have to navigate an evolving but ostensibly challenging landscape. For investors seeking exposure to residential mortgage credit, this challenge is even more pronounced. Although the Bloomberg Barclays Aggregate Index has a sizeable exposure to agency-backed residential mortgages (28% as of October 31, 2016), other securitized sectors are underrepresented. Due to the nature of the agency guaranty in agency RMBS, there is little to no exposure to the credit component. As a result, interest-rate risk is the dominant driver of return for agency-backed residential mortgages.

In this Market Insights Series, we explain how investors can benefit from other areas of the securitized market. This paper focuses on Credit Risk Transfer (CRT), a relatively new and growing market segment that provides investors seemingly elusive access to mortgage credit exposure. CRT securities are floating-rate instruments that deliver minimal duration risk, credit spreads in excess of many fixed income sectors and, ultimately, the potential to increase risk-adjusted returns across a wide range of economic scenarios. In this paper, we explore the structure of CRT securities and the market characteristics that are making them attractive investment opportunities in the current environment.

Credit Risk Transfer in a Nutshell: What are Government Sponsored Enterprises Trying to Accomplish?

In support of their federal mandate, government sponsored enterprises (GSEs) such as Freddie Mac and Fannie Mae finance their mortgage exposure via issuance into the securitization market. Securities are collateralized by residential mortgages, with repayment driven by underlying borrowers—and their prepayment option. However, the GSEs have historically retained the risk of borrowers defaulting on their mortgages. While this contributes to lower financing costs, it exposes these entities—and by extension, U.S. tax payers—to significant amounts of credit risk. As of September 30, 2016, aggregate agency-backed mortgages totaled $5.9T.[1]

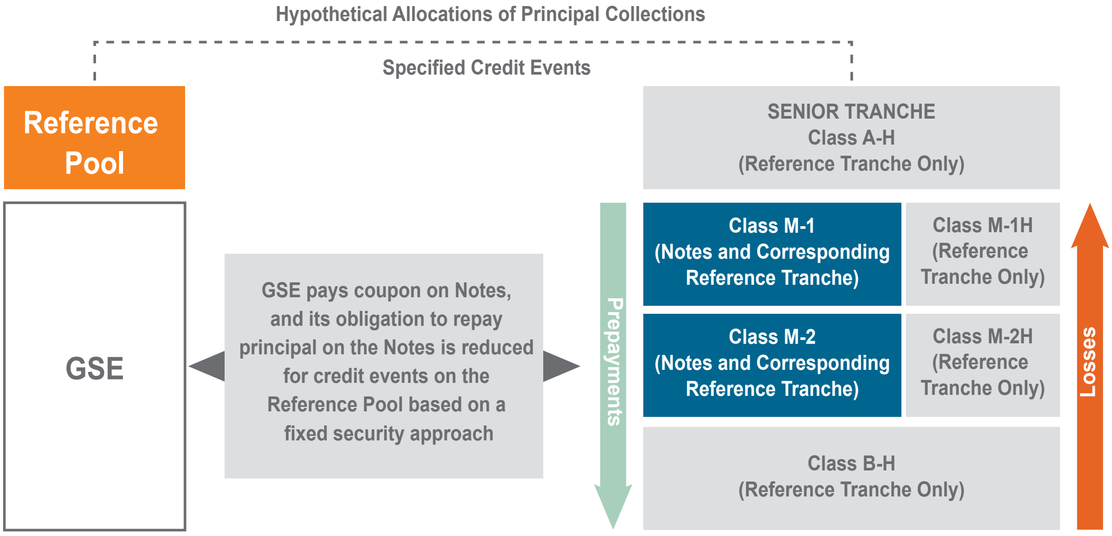
In the 2008 credit crisis, the negative consequences of outsized and—at that time—poorly underwritten credit risk became clear. Housing market values collapsed and mortgage delinquencies and defaults surged. Fannie Mae and Freddie Mac lost billions of dollars on their investment portfolios and MBS guarantees. Foreclosures and losses mounted and investor confidence in the GSEs deteriorated. This sequence of events led to a sharp increase in borrowing costs for GSEs and drastic declines in shareholder equity, triggering concerns about systematic failure. Fannie Mae and Freddie Mac were ultimately placed into conservatorship by their regulator, the Federal Housing Finance Agency (FHFA). As part of this arrangement, the two government sponsored enterprises received lines of credit and preferred stock from the U.S. Treasury, effectively amounting to a bail-out from U.S. taxpayers.

In the wake of the crisis the FHFA outlined a strategic plan to reduce the risk posed to tax payers from Fannie Mae and Freddie Mac. As part of this plan, a primary challenge emerged: how to reduce risk to the U.S. tax payer and the financial system, but do so in a way that preserves efficient and reliable borrower access to mortgage credit. To assist in meeting this challenge, the “Credit Risk Transfer” securitization market was created.

After years of planning and consultation with capital market participants and regulators, CRT issuance commenced in 2013. Both Freddie Mac and Fannie Mae issued publicly registered securities, via Structured Agency Credit Risk (STACR) and Connecticut Avenues Securities (CAS) transactions. With the successful issuance of these fixed income instruments, the GSEs effectively purchased protection against potential default risk from their mortgage borrowers via capital markets investors. The GSEs continued to collect their normal guarantee fees from lenders for covering borrower credit risk, but now compensated investors in STACR and CAS transactions for taking portions of that same risk.

[1] Source: Urban Institute

Figure 1. Example of CRT Structure



How Has Credit Risk Transfer Evolved?

The concept of credit risk transfer is not new. Before the 2008 crisis, GSEs selectively used "front end" forms of credit protection tools such as primary mortgage insurance and mortgage insurance pool policies. The more recent "back end" efforts to transfer credit risk are different for two primary reasons: scale and structure.

Since 2013 CRT has provided GSEs with loss protection on more than $1.2T of mortgage loans.[2] For perspective, in 2012 less than 50% of mortgage loans acquired by Fannie Mae utilized CRT (via "front end" forms of credit protection)—by the end of 2015, with the increased usage of back end CRT, the number of mortgage loans utilizing CRT had grown to more than 95%. In addition, regulator driven scorecards for the GSEs (now issued annually) prescribe at least 90% of newly produced mortgages utilize CRT.

In a typical CRT structure (Figure 1), the GSE retains all of the most senior tranche and portions of the mezzanine and first loss piece (per risk retention regulations), while selling the non-retained mezzanine and first loss tranches to investors.

While CRT transactions have evolved since 2013, all of the offered securities have been structured as uncapped 1 month LIBOR based floaters. Securities pay interest and principal monthly, mimicking the payments made by the underlying reference pool through time. Although the details vary by transaction, generally the GSEs are required to buy back the notes at par in 10-13 years and have the option to call the transaction at 10% of the original balance.

Different flavors of credit risk have emerged as investor acceptance of the CRT market has increased. Examples include transactions collateralized by borrowers with higher loan-to-value mortgages (i.e. >80%), transactions that pass through actual losses on resolved foreclosures (as opposed to prescribed loss severities) and sale of a portion of the first loss risk position.

The Current Benefits of CRT Securities

Recall that with agency RMBS, the GSEs insulate investors from risk of borrower default, a structure that exposes the GSEs to significant amounts of credit risk. The CRT structure outlined in figure 1 allows GSEs to transfer a portion of this risk to investors. So is the risk worth taking? The short answer is yes.

For multi-sector fixed income and securitized credit portfolios, CRT transactions offer diversifying exposure to residential mortgage credit. Given that many of the underlying fundamentals of CRT securities are driven by the U.S. housing markets and homeowners, investors in CRT can gain focused, direct exposure to these stable—if not outperforming—parts of the global economy.

In addition, and of particular importance, borrowers referenced by STACR and CAS CRT deals have been underwritten using the more rigorous, post-credit crisis imposed lending standards and are subject to risk-sharing requirements imposed by regulators. With these dynamics in play, these mortgage loans exhibit credit characteristics vastly superior to those underwritten in pre-credit crisis vintages. The market backdrop is also supportive as housing market values continue to recover to pre-crisis levels. Analysis that replicates varying degrees of home price depreciation has been conducted to project potential borrower behavior in various CRT transactions. This analysis suggests acceptably low credit-losses (i.e. covered by structural protections) under a wide range of potential scenarios.

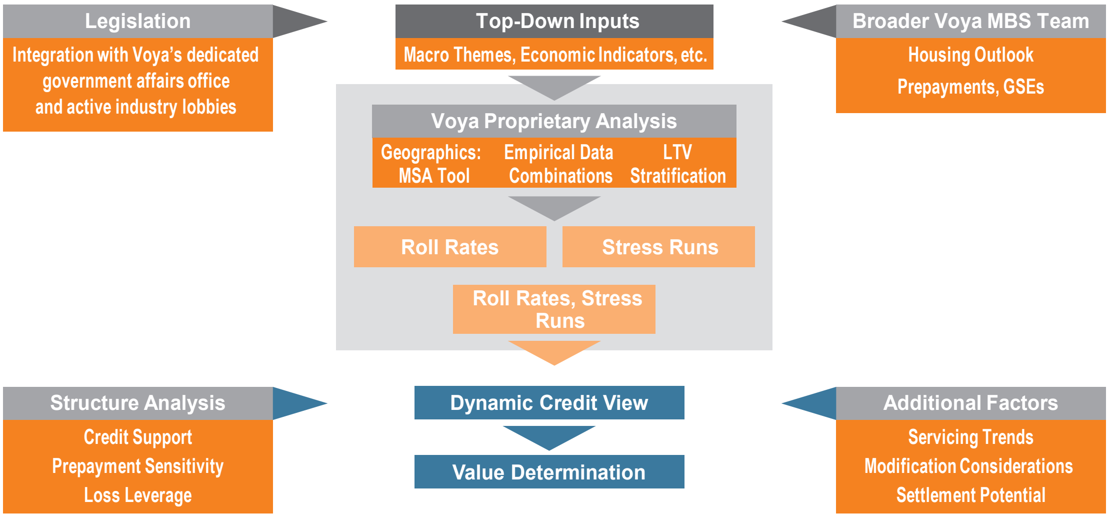
Furthermore, while transactions are relatively early in their life cycle, delinquency and loss experience to date has outperformed agency mortgage experience from prior vintages. The cumulative net loss for 2015 and 2016 Structured Agency Credit Risk transactions has been less than 10 bps.[3]

Also from a diversification perspective, CRT securities are LIBOR based instruments, which reduces correlation with the Barclays Aggregate and other longer duration fixed income markets and helps protect portfolios in a rising rate environment.

[2] Source: Fannie Mae, Freddie Mac, Nomura

[3] Source: Freddie Mac

Figure 2. Voya's Culture of Collaboration: The Many Facets of CRT Research



CRT securities are issued as GSE debt and therefore do not constitute the sale of mortgage loans. Instead, cash flows track the performance of a reference pool of mortgages. Each reference pool contains all loans that the respective GSE originated and guarantees within a specified prior timeframe (typically a few months). These reference pools are subject to a set of broad criteria meant to insulate investors from fraud risk. For example, 30-year mortgages with 60-80% loan-to-value ratios that have never missed a payment and have passed through the agency's quality control measures. To the extent a borrower ultimately defaults, and it is later determined these quality control measures failed, CRT transactions provide for a transparent process (via representation and warranty) by which the responsible GSE will repurchase such loans from the transaction, at par. This mechanism, absent from pre-crisis issued private label transactions, helps mitigate investors from potential fraud risk.

From an idiosyncratic risk perspective, the mortgage pools underlying CRT investments often reference over 100,000 underlying loans, which delivers significant diversification of collateral within each pool. This includes the crucial dimension of geography, where pre-crisis non-agency RMBS transactions often were accompanied with significant exposure to particular states and/or MSAs that underperformed as home prices corrected.

Despite the strong credit and diversified collateral of CRT securities, the market segment currently offers attractive spreads relative to other fixed income sectors. The back-end mezzanine pieces in CRT transactions currently trade between L+250 and L+500 to our analysis of realistic prepayment and loss scenarios. It is important to note that these assumptions, as well as credit spreads will vary through time with changes in market conditions. Nevertheless, the current spreads of CRT represent attractive fundamental value given the various collateral and structural related dynamics described above. More tactically, given recent dynamics in rating agency ratings on CRT issuance (upgrades) and with NAIC scoring of CRT instruments, more seasoned transactions continue to trade with improved liquidity.

Why Aren't More Investors Capitalizing on CRT?

While investors are increasingly recognizing the attractive elements of CRT, the opportunity to obtain attractive spreads persists. This is in part because the asset class is still fairly new and structures continue to evolve, leaving many investors without the needed expertise to evaluate opportunities in the sector. Also, many large investors are prohibited from investing in these securities because meaningful portions of the universe do not currently carry investment grade ratings from nationally recognized statistical rating organizations (NRSROs).

Capturing CRT opportunities requires a comprehensive view of the housing market and the expertise to perform rigorous bottom-up research on the credit risk in each investment's underlying collateral pool (Figure 2). Detailed appreciation of agency underwritten borrowers also provides an advantage to investors in CRT. This is particularly true in periods of elevated interest-rate volatility, given the potentially more significant implications on borrower prepayment behavior. At the same time, the importance of evaluating structural characteristics cannot be underestimated. Two securitized investments with the same collateral characteristics may produce varied performance due to different structural components.

The Benefits of Securitized Credit

Given the dynamic of the Bloomberg Barclays Aggregate Index, exposure to residential mortgage credit is likely underrepresented in most investors' portfolios, which limits the ability to benefit from the many diversification and return benefits of adding this exposure. For investors seeking greater, diversified exposure to the U.S. consumer and housing, opportunities abound in the securitized credit markets (Figure 3).

Figure 3. Looking Beyond Agency RMBS: The Potential Diversification Benefits of Securitized Credit

	ABS	CLO	CMBS	Non-agency RMBS	Credit Risk Transfer
Primary Fundamental Driver	Consumer	Corporate credit cycle	Commercial real estate	Housing market	Housing Market
Secondary Fundamental Driver	Access to credit	Manager skill	Labor market	Labor market	Labor Market
Key Sector Specific Risk	Student loan market dynamics	Regulatory compliance	Maturity wall	Mortgage servicing risk	GSE Reform
Typical Credit Rating	High investment grade	Mid to high investment grade	Low investment grade	Below investment grade	Below - Low IG
Weighted Average Life	<= 5 years	<= 10 years	3-10 years	4-6 years	2-10 Years
Fixed or Floating	Mixed	Floating	Fixed	Mixed	Floating
Market Size ($ Billions)	$714	$440	$530	$859	$30

Source: Voya Investment Management, SIFMA and Bloomberg. Market size represents outstanding balances as of 9/30/16.

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